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Corporate Financial Statements: A Product of the Market and Political Processes

by

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Abstract:

An outline for a theory of financial statements is presented. Financial statements are viewed as products of both markets and political processes and the interactions among individuals and groups in these processes. Individuals are assumed to maximise their self-interests. Various hypotheses and data are provided to illustrate the theory. It relies heavily on theory of agency, economic regulation and public choice. At this stage, the theory has great promise in explaining the form and contents of financial statements. The theory contrasts with earlier 'normative' theories of financial statements and offers an explanation for the forms they take.

Keywords:

ACCOUNTING PROCEDURES; ACCOUNTING THEORY; AGENCY; ECONOMIC REGULATION; FINANCIAL STATEMENTS; PUBLIC CHOICE.

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An earlier version of this paper was presented at the Annual Congress of the New South Wales Branch of the Institute of Chartered Accountants in Australia in June, 1970. Many of the ideas in that earlier paper evolved from discussions I had with M. Jensen while we were trying to write a paper on accounting theory. The concepts in this paper are substantially more developed than in the original paper. Some of those developments were conceived during attempts by J. Zimmerman and myself to test hypotheses generated by the 1974 paper. A major development, the structure of the Agency Problem, was provided by Jensen and Meckling (1976). Thus I owe a great deal to Jensen, Meckling and Zimmerman. However, they are not responsible for any errors in the paper. I am also indebted to G. Benston, B. Hoithausen, M. Krasney, B. Leftwich and C. Smith for their helpful comments and suggestions.

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1. INTRODUCTION

The financial accounting literature concentrates on prescriptions: on what "should" be the content of financial statements.¹ Very little attention is given to developing a theory to explain many interesting observed phenomena; in particular to explain why financial statements take their current form. In other words, the literature is unscientific.² We have no theory of corporate financial statements, in the form of a group of internally consistent, interrelated hypotheses which have been subjected to formal tests and "confirmed".

Prescriptions in the accounting literature are based on hypotheses about observed phenomena in capital markets, political process, and other areas. Rarely do any of the prescribers suggest that the hypotheses be tested formally, let alone perform such tests. Moreover, the hypotheses are often inconsistent with currently accepted theories in finance and economics.³

Even that part of the accounting literature which relies on the empirically-based efficient market hypothesis and the capital-asset-pricing models of finance does not include any tests of hypotheses which directly explain why financial statements take their current form. Instead, the emphasis in that finance-based literature is on stock market reaction to the content of financial statements.⁴

The development of prescriptions and the development of theory are not incompatible. The development of prescriptions which are likely to achieve their objectives requires an underlying theory which explains observed phenomena: which predicts the effects of particular prescriptions. Thus, given the concentration on prescriptions, the lack of development of theory in financial accounting is an enigma.

The purpose of this paper is to provide an outline for a theory of financial statements and to provide examples of some of its constituent hypotheses. The approach is based upon price theory. It assumes that individuals maximize their own expected utilities and that they are innovative and creative in doing so.⁵ Financial statements are viewed as resulting from interaction among these maximizing individuals in both markets and the political process. No one individual or group of individuals is viewed as determining the form of financial statements. The outline relies heavily on theories of agency, public choice and economic regulation.⁶ A justification for these assumptions and for the reliance

¹For example see Sanders, Hatfield and Moore (1938), Paton and Littleton (1940), Edwards and Bell (1961), Sprouse and Moonitz (1962), Gordon (1964), American Accounting Association (1966), Chambers (1966), and Ijiri (1967).

²This observation is also made by Jensen (1976, p.11). Jensen also argues for a positive theory of accounting.

³For example, Chambers (1966, p.293) asserts: "Statutes and regulations secure the rights of investors, potential investors, their advisers, their agents, and the public generally, to authenticated financial information, with the object of creating a fair and informed market in securities." This implies that the object of securities statutes and regulations is what is called in economics "the public interest". Convincing evidence that this is not the objective of statutes and regulations is supplied by Posner (1974) among others. Chambers does not present any evidence to support his assertion.

⁴See Conedes and Dopuch (1974) for a review of this literature.

⁵For a discussion of the importance of this assumption, see Meckling (1976b).

⁶See Jensen and Meckling (1976b) for a theory of the firm based upon the agency relationship, Mueller (1976) for a summary of the theory of public choice and

on these other theories is the rich set of testable hypotheses generated about corporate financial statements and the extent to which those hypotheses are consistent with observed phenomena. Casual empiricism confirms some of these hypotheses. The few that have been formally tested have been confirmed.⁷

Another purpose is to propose an hypothesis which explains the enigma of the accounting literature: the emphasis on prescriptions and the simultaneous lack of emphasis on accounting theory (i.e. explanation of observed phenomena) which is necessary for successful prescription. This hypothesis is explored in greater depth in Watts and Zimmerman (1977).

The next section of this paper discusses the market interaction of individuals associated with the corporation. Hypotheses about the content of financial statements are drawn from that discussion. In section 3, the political interaction of expected-utility maximizing individuals is examined and additional hypotheses about the content of financial statements are provided. Examples of observed phenomena which these hypotheses can explain are also contained in sections 2 and 3. Section 3 also provides an hypothesis to explain the abundance of prescriptions without theory in the accounting literature. The conclusions are set out in section 4.

The reader should bear in mind that I am only proposing hypotheses. These proposals are based on theories drawn from finance and economics and apparently are consistent with a range of observed phenomena. Thus I believe there is a high likelihood that a theory can be developed from the approach adopted in the paper. Whether that belief is justified or not will be determined by the ability of my hypotheses to withstand formal empirical testing.

2. CORPORATE FINANCIAL STATEMENTS AND THE MARKET PROCESS

2.1 *The Agency Relationship and Financial Statements*

Corporations listed on stock exchanges are owned by shareholders, but they typically are managed by individuals who own only a small fraction of the outstanding shares. Because I assume that all individuals, including shareholders and managers, maximize their own expected utilities, this situation implies a conflict: actions that maximize managers' expected utilities do not necessarily maximize shareholders' expected utilities.

The relationship between shareholders and managers is an agency relationship. Jensen and Meckling (1976b, p.308) define an agency relationship as "a contract under which one or more persons (principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent". Shareholders are principals in the relationship and managers are agents.

There is a growing literature in economics on the agency relationship.⁸ Most of it addresses the reconciliation of conflict: construction of incentives for the agents to act in the principal's interest. In other words, most of the literature is normative. In contrast, Jensen and Meckling (1976b) have investigated the positive aspects of the agency relationship as it applies to corporations. They define the concept of agency costs, analyze the incentives of principals and agents and derive formal hypotheses about the contractual arrangements one would expect to observe in equilibrium. Further, they suggest

⁶(cont'd.) Posner (1974) for a summary of alternative theories of economic regulations.

⁷See Watts and Zimmerman (1977b).

⁸See Berhold (1971), Ross (1973, 1974), Wilson (1968, 1969) and Heckerman (1975).

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that audited corporate financial statements are part of an equilibrium result.

I believe that an analysis of the role of corporate financial statements in the agency relationship can contribute much to our understanding of the development of accounting (i.e. to a theory of accounting). In this section of the paper I provide the grounds for that belief. I investigate the implications of Jensen and Meckling's analysis for the content of financial statements and provide examples of hypotheses which can be derived from their analysis. These hypotheses appear to be consistent with observed phenomena. Finally, I examine the relationship between the function of corporate financial statements in the agency relationship and the information function of financial statements which has been proposed frequently in the accounting literature.

2.1.a The costs of the agency relationship and who bears them

Jensen and Meckling (1976b, p.308) define the costs of the agency relationship (agency costs) as the sum of three components:

1. monitoring expenditures by the principal
2. bonding expenditures by the agent
3. the residual loss.

Monitoring expenditures are expenditures by the principal to "control" the agent's behaviour (e.g. costs of measuring and observing the agent's behaviour, costs of establishing compensation policies, etc.). The agent has incentives to make expenditures to guarantee that he will not take certain actions to harm the principal's interest or that he will compensate the principal if he does. These are bonding costs. Finally, even with monitoring and bonding expenditures, the actions taken by the agent will differ from the actions the principal would take himself. Jensen and Meckling define the wealth effect of this divergence in actions as the "residual loss".

Jensen and Meckling analyze the effect of both outside equity and debt on agency costs. They compare the behaviour of a manager when he owns 100 per cent of the equity in a firm (owner-manager) with his behaviour after he sells off some of that equity. They show that if the equity market is competitive and makes unbiased estimates of the effects of monitoring and bonding expenditures, then the owner-manager bears the total wealth effect of the expected agency costs of creating outside equity. Thus, the manager has an incentive to reduce expected agency costs. He writes contracts for monitoring and bonding as long as the marginal benefits of those contracts (in terms of reduction of residual loss) are greater than the marginal costs (direct costs of the covenants and the utility of the prerequisites foregone).

There are agency costs involved in debt financing also. Jensen and Meckling show (p.335) how, in the absence of monitoring or bonding contracts, an owner-manager can increase his wealth at the expense of bondholders by first selling bonds with the loose promise to invest in a project with a low variance of return and by then investing in a project with the same systematic risk but a higher variance of return.⁹ However, Jensen and Meckling argue, the bondholders realize that he will do so, as a wealth-maximizer, and they will price the bond accordingly. In addition, if the high variance project has a lower expected return than the low variance project then the total value of the firm is reduced by the manager investing in the high variance project. This wealth loss is the "residual loss" portion of the agency costs of debt. This "residual loss" is borne by the owner-manager, so he has an incentive to reduce the total agency costs of debt by

⁹The term "systematic risk" is used as in the Sharpe (1964)-Lintner (1965) capital asset pricing model.

offering monitoring and bonding contracts.¹⁰

There are abundant examples of monitoring and bonding arrangements which are consistent with the hypothesis that managers seek to reduce the agency costs of both debt and equity. One of the most common examples is the covenant that restricts the payment of dividends. Without this restriction we would expect managers and shareholders to "steal" the assets of the corporation and leave the debt-holders with the "shell" of the corporation.¹¹ This covenant is not only common; it is also old. As early as 1620, a corporate charter included a limitation that dividends only be paid from profits.¹² Since we observe some company charters after that date and not including the dividend covenant, it appears that this company's covenant was voluntarily included by its promoters.¹³

An example of monitoring and bonding activities to reduce the agency costs of equity, is a management compensation plan which ties management wealth to shareholder wealth, directly via stock options or indirectly by bonus plans in which the bonus depends on net income.¹⁴ Management compensation plans of this kind have existed for many years. For example, in 1887 the Leeds Estate Building and Investment Company's articles included a provision whereby the manager and the directors were entitled to a bonus based on the amount of profits available for dividends.¹⁵ Another example is provided in the Spanish Prospecting Company case of 1911. An officer of the Spanish Prospecting Company was entitled to salary "only in the case of there being sufficient profits arising from the business to provide for its payment" [Hatfield (1927, p.281)]. I suspect that these are not isolated examples; in fact, I hypothesize that the management compensation of U.K. companies in the nineteenth century usually was tied to the "profits" of the company.¹⁶

2.1.b *The role of audited financial statements in reducing agency costs*

Jensen and Meckling (1976b, p.338) provide an example of the way in which audited financial statements can reduce agency costs:

Suppose, for example, that the bondholders (or outside equity holders) would find it worthwhile to produce detailed financial statements such as those contained in the usual published accounting reports as a means of monitoring the manager. If the manager himself can produce such information at lower costs than they (perhaps because he is already collecting much of the data for his own internal decision making purposes), it would pay him to agree in advance to incur the cost of

¹⁰The agency costs of debt and the manager's incentives to reduce them are also analyzed by Black, Miller and Posner (1974) and Myers (1976).

¹¹For a statement of the purpose of dividend covenants see "Excerpts from Manual on Framing Loan Covenants" in Black, Miller and Posner (1974). Black and Scholes (1973), Black, Miller and Posner (1974) and Myers (1976) investigate the implications of dividend restrictions for the valuation of debt.

¹²The company was the New River Company. See Kehl (1941, p.4).

¹³Kehl (1941, p.4) states that the inclusion of such dividend covenants in corporate charters began in the 1600's and that they became "increasingly more common" during the eighteenth century. This suggests that not all corporate charters included them in the 1600's.

¹⁴Conference Board (1974).

¹⁵See Edwards (1968, p.148).

¹⁶I discuss the definition of "profits" and its relationship to shareholder wealth later in this section of the paper.

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providing such reports and to have their accuracy testified to by an independent outside auditor.

In an unregulated economy, without legally-required corporate financial statements, we could observe corporate financial statements fulfilling the function of reducing agency costs. An opportunity to test this hypothesis is provided by the nineteenth century, in which corporations in both the U.S. and the U.K. were not generally required to present financial statements.¹⁷ Were corporate financial statements used in that period to reduce agency costs? Did promoters/managers voluntarily contract at the time of selling debt or equity to supply outside equity and debt-holders with information useable for monitoring their own actions? Whether or not the types of information observed in financial statements in the nineteenth century could serve to reduce agency costs is relevant to these questions. Since this depends on the form on the monitoring and bonding contracts, we first note some of the contracts existing in the nineteenth century.

One such contract is the compensation scheme. Jensen and Meckling (1976b, p.323) hypothesize that monitoring and bonding contracts which tie the incentives of the manager more closely to the outside equity holders' interests (such as compensation schemes dependent on shareholder wealth) can reduce agency costs. I have noted the existence of such contracts in the U.K. in the late nineteenth and early twentieth centuries.

I have indicated that covenants restricting the payment of dividends to the amount of profits reduce the agency costs of debt. They also reduce the agency costs of preferred equity capital. Such covenants were common in the articles of corporations in the nineteenth century.¹⁸ Indeed the famous nineteenth century cases on the definition of profits arose because of such covenants.¹⁹

A third covenant which also reduced the agency costs of debt and preferred equity existed in the articles of some U.K. corporations in the nineteenth century. That covenant restricted the payment of dividends to the amount of profits remaining after deducting a reserve fund for maintenance, repairs, depreciation and renewals. An example of the covenant is the 104th article of London Tramways Company as reported in the action Davison vs. Gillies (1879).²⁰ The articles of some other corporations did not require a deduction for depreciation (e.g. the Neuchatel Asphalt Company).²¹ The courts took the presence or absence of this covenant on depreciation seriously. They did or did not require depreciation to be deducted before determining profits available for dividend depending on whether the articles did or did not include the covenant.²² I predict that in the nineteenth century the articles of U.K. corporations included many other types of covenants which reduced agency costs of outside equity and debt. Detailing all those covenants is beyond the scope of this paper. The important point is that in order to monitor the three forms of covenant mentioned above, the outside

¹⁷See Benston (1976, chapter 2, pp.14-22).

¹⁸The U.K. Companies Act of 1862 did not require dividends to be paid only out of profits [Brief (1976, p.17)].

¹⁹See Brief (1976) and Hatfield (1927) for descriptions of these cases.

²⁰See Dent vs. The London Tramways Company (Limited) in Brief (1976, p.193).

²¹See Lee vs. Neuchatel Asphalt Company in Brief (1976, p.19).

²²Ibid. Also see Litherland (1968). Litherland is quite explicit (p.171): "the question of depreciation was a matter of internal management with which the law had nothing to do. The Articles of the given company were to govern".

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equity holders and debt holders need an observable estimate of what they understand to be profits. Moreover, that estimate can not be under the sole control of management. Thus, if managers offered those covenants on bonding contracts in the nineteenth century, I expect that they also bonded themselves to provide audited financial statements.

During the period 1856 to 1900, U.K. corporations were not required by law to provide financial statements to shareholders or to bondholders. If supplied, they were not required by law to be audited.²³ However, the Joint Stock Companies Act of 1856 did include a model set of articles. Those articles were also included in the 1862 Companies Act as Table A. The articles required directors to present to the annual general meeting of a company a Statement of Income and Expenditure including, among other things, a balance of profit or loss and a Balance Sheet.²⁴ The articles also required the appointment of auditors and required those auditors to report upon the Balance Sheet and accounts. The court decided in 1887 that the articles made the auditor responsible for the soundness of the "profit available for dividend" number reported in the financial statements.²⁵

During the 44-year period 1856 to 1900 many promoters of managers or corporations voluntarily bonded themselves by accepting the model articles or at least articles including the requirement to present audited financial statements. It was "not unusual" for the accounts of well-known corporations to be audited in that period and by the end of the period the professional auditor was "an accepted part of the scene".²⁶

2.1.c Implications for financial statements in an unregulated economy

The argument, that a function of audited financial statements in an unregulated economy is to reduce agency costs, could explain which corporations present financial statements and how the contents of those statements vary across corporations. Thus, Jensen and Meckling's analysis has the potential to produce a theory of corporate financial statements. Whether or not it does so depends upon the ability of derived hypotheses to withstand empirical testing. In this section I provide examples of derived hypotheses which can be tested.

If the function of financial statements is to present numbers for monitoring covenants, then I expect to observe nineteenth century corporations voluntarily presenting financial statements when such covenants exist.

Hypothesis 1: The greater the number of bonding covenants dependent on financial numbers entered into by the corporation, the greater the likelihood that the corporation presented financial statements.

The above test of the proposed theory is not very strong. Covenants could exist for reasons other than to reduce agency costs and the financial statements could exist purely because of the covenants. A stronger test would be to predict which corporations in an unregulated economy are likely to have bonding covenants and hence are likely to present financial statements. The analysis of Jensen and Meckling (1976b) enables such a prediction. They predict (pp.346-7) that the

²³See Edey (1968, p.137) and Edey and Panitpakdi (1956). However, note that auditing was required for banks by the Companies Act of 1879 and life insurance companies were required by the Life Assurance Companies Act of 1870 to provide financial statements upon request to shareholders and policyholders.

²⁴See Edey and Panitpakdi (1956, pp.362-364).

²⁵See the Leeds Estate Building Company case in Edwards (1956, p.148).

²⁶Edey (1968, p.137).

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optimum level of monitoring increases as the ratio of the managers' share of equity to outside equity falls. Further, they also predict (p.347) that (holding the managers' share of equity constant) the larger the corporations' outside debt the larger the optimum level of monitoring. Both of these predictions provide hypotheses which could be tested using nineteenth century data on corporations which were not required by statute to present financial statements.

Hypothesis 2: The smaller the managers' total relative share of the corporation's equity the greater the likelihood that the corporation presented financial statements.²⁷

Hypothesis 3: The larger the absolute amount of the corporation's outside risky debt, the greater the likelihood that the corporation presented financial statements.

The analysis of agency costs can provide predictions on the contents as well as the existence of financial statements in the absence of statutory requirements. The contents will vary across corporations as bonding covenants vary.

Consider management compensation schemes as illustrating how a particular type of covenant can vary across corporations and as illustrating the effect of that variation on financial statements. The ability of a particular compensation scheme to reduce agency costs depends upon the extent to which the index used for compensation correlates with the interest of the outside shareholders and upon the cost of calculating and applying that index. The degree of correlation and the costs of calculation and application of a particular index will vary across corporations and industries. Hence I expect to observe compensation indexes varying across corporations.

One index used for management compensation in the nineteenth century was "profits". Examples are found in the articles of the Leeds Estate Building Company and the Spanish Prospecting Company reported earlier. According to Litherland (1968, p.171) "profit was calculated in the trading section of the balance sheet as the excess of revenue receipts over properly chargeable expenditures". The accrual concept was not recognized.²⁸ Further, as I have indicated depreciation was a matter for management and generally was treated as an allocation of profit.²⁹ Hence "profits" generally were calculated to approximate operating cash flows.

Changes in a corporation's earnings and operating cash flows are highly associated with changes in the market value of the corporations' shares.³⁰ Thus

²⁷Jensen and Meckling analyze the agency costs involved in a single manager situation. In practice corporations usually have many managers. This undoubtedly makes the analysis more complex. I consider the Jensen and Meckling analysis as a simplification which is justified if it produces implications which are consistent with observed phenomena. If a corporation has more than one manager we could sum all the equity shares of the managers for the purpose of testing this hypothesis.

²⁸Litherland (1968, pp.171-172).

²⁹This statement is based on the writings of accounting historians. To check whether it is correct I examined the annual reports of the U.S. non-railroad corporations in the Commercial Chronicle in the last decade of the nineteenth century and the first decade of this century. Since there was a close relationship between U.K. and U.S. accounting practices at that time, the practices of those U.S. corporations should provide evidence on U.K. practices. I found that the majority of those U.S. corporations which did take depreciation charged it to Retained Earnings.

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the "profits" index would correlate with the interests of outside shareholders. However, it also provides an important incentive for the manager to act against the shareholders' interests. For example, the manager can increase current operating cash flows (and hence his income) at the expense of future cash flows (and the market value of shares) by reducing maintenance expenditures and allowing fixed assets to deteriorate.

One way to reduce this imperfection of the "profits" index is to adjust the index: i.e., to re-define the index as "profits" less an allowance for repairs and maintenance and depreciation of fixed assets. Since articles did include covenants requiring the deduction of such allowances in order to determine profits available for dividend (e.g. the London Tramways Company referred to earlier), I would predict that some management compensation schemes also used "profits" after depreciation as their index. In fact, since the agency cost of calculating cash flow "profits" would increase as the amount of the corporations' fixed assets increased, I would predict that the greater the value of the corporation's fixed assets the more likely it is that the corporation's management compensation scheme used profits after depreciation as its index of shareholder interest. This prediction in turn provides an hypothesis about the variation of the content of financial statements across corporations in the nineteenth century.

Hypothesis 4: The greater the value of a corporations' fixed assets, the greater the likelihood that its financial statements included an allocation of profits for renewals, repairs, maintenance or depreciation.

It is interesting to note that a covenant requiring a manager to allocate profits for renewal, repairs, maintenance or depreciation could also reduce the agency costs of debt. Myers (1976) analyzes the effects of agency costs on corporate borrowing. He concludes (p.30) that relatively more debt will be used to finance "assets-in-place" (assets already owned) than will be used to finance growth opportunities (future investments). This conclusion comes from an assumption that greater restrictions can be placed on management's discretion in the case of existing assets and hence agency costs of debt used to finance existing assets will be lower. The requirement to set aside profits for renewal, repairs, maintenance or depreciation of existing assets is one such restriction.

2.1.d The effect of regulation of financial statements on agency costs

The above hypotheses illustrate the way in which accounting practices can be explained by a theory of agency costs. Many more hypotheses can be generated from that theory, about current practice as well as practice in the nineteenth century. The nineteenth century is chosen because the influence of the market on accounting practice in that time period is more readily apparent. There were fewer legal requirements and fewer effects of the political process.

In a regulated economy, the manager of a corporation still has the incentive to reduce agency costs. We observe him engaging in bonding activities. Also, we can observe the corporation's published audited financial statements being used to monitor bonding covenants.³¹ However, regulations and statutes now have an impact on the contents of those statements. The agency cost theory of accounting

³⁰See Ball and Brown (1968).

³¹For example, Brunswick Corporations' Note Agreement with the Prudential Insurance Company of America (dated May 11, 1976) includes (page 5) an affirmative covenant requiring the corporations' management to deliver quarterly and annual financial statements to Prudential. The annual financial statements must be certified by the auditors who must also certify that they have no knowledge of any defaults on the covenants in the note agreement.

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is rich enough to predict effects of changes in financial statements, due to the political process, on actions of managers and investors.

An examination of U.S. lending agreement covenants indicates that the impact of regulation on the contents of financial statements has not always been to the advantage of investors. For example in Brunswick Corporation's May 11, 1976 Note Agreement with Prudential Insurance Company of America, the definition of earnings available for dividends excludes certain gains (non-cash items) which have been required to be included in reported net income by various U.S. accounting standard setting bodies.³²

I hypothesize that had reported profits consisted of operating cash flows as in the nineteenth century, the extra bonding costs of devising these exclusions would not have been incurred. These extra bonding costs were borne by the residual-claim holders (shareholders and management) at the time the accounting standards were announced.

The proposition that accounting standards have increased legal costs can be tested. An examination of U.S. accounting standards since the standard setting process began with the Committee on Accounting Procedure (C.A.P.) in 1939 should identify standards which could cause reported profits to increase by the inclusion of non-cash accruals (income-increasing standards). By comparing a sample of loan agreements before and after the announcement of income-increasing standards I can test the following hypothesis.

Hypothesis 5: Loan agreements made after the requirements of an income increasing standard are more likely to incorporate covenants eliminating the particular accrual from the profits available for dividend.

I hope that the above examples have made it clear that an agency cost theory of corporate financial statements is potentially a rich source of hypotheses about accounting practice. However, it does not explain the form and nature of the regulations and statutes that affect financial statements. A theory with the potential to explain regulations and statutes is outlined in section 3.

2.1.e The agency relationship in the accounting literature

Accountants have long been aware of the importance of the agency relationship in explaining observed accounting practice. Yamey (1962, p.15) suggests that accounting began because of the agency relationship: "The origins of accounting and indeed of written records are probably to be found in the need of an 'accounting' officer to render a statement of money and other assets received in his charge on behalf of his employer or disbursed on his behalf. There was a need for a check on the honesty and reliability of subordinates." De Ste Croix (1956, p.38) states that the purpose of Greek and Roman accounting was to disclose any "loss due to dishonesty or negligence" of subordinates (i.e., agents).

The idea that the purpose of accounting is to check the honesty and reliability

³²Examples of those gains which are excluded in the agreement include: (1) gains from "the sale, conversion or other disposition of capital assets" which could have been credited to Retained Earnings instead of Income if the U.S. Securities and Exchange Commission (S.E.C.) had not adopted a "clean-surplus" policy; and (2) income arising from accounting for investment by the equity method required by the Accounting Principles Board (A.P.B.): i.e., the corporation's share of the profits retained by a subsidiary.

Note that while accounting standard setting-bodies like the A.P.B. did not have legal power to enforce their standards, they did have the backing of the S.E.C. which did have the power [see Horngren (1976)].

of agents is called the "stewardship" concept in the accounting literature. It has been used to explain, among other things, feudal accounting in England [Littleton and Zimmerman (1962, p.23) and Yamey (1962, p.15)] and the financial reporting provisions of the British Companies Act of 1847 [Littleton and Zimmerman (1962, p.84)]. Thus the idea that the agency relationship can explain accounting practice is not new. What is new in this paper is recognition of the relationship between agency costs and financial statements: the recognition that promoters and managers of corporations offering new issues of shares or debt have incentives to reduce agency costs, to contract (e.g. in corporate articles) to reduce those costs and to contract to supply monitoring information in financial statements. This formal structuring of the role of financial statements in the agency relationship makes it possible to formulate consistent, interrelated hypotheses about accounting practice and to test them. It provides a means of carrying out the suggestions of Edey and Panitpakdi (1956, n.14) that accountants study "the extent to which the pressure of the market brought about voluntary improvements in the presentation of corporate accounting information in the late nineteenth century."

2.2 *The Information Hypothesis as an Explanation of Financial Statements*

Many papers in the accounting literature argue that the function of corporate financial statements is and should be to provide information useful to investors in their investment decisions (the information function).³³ Information for monitoring bonding covenants is useful information to investors, so the functions overlap. However, the emphasis is different. Information for monitoring bonding covenants is contracted for in advance as part of a mechanism by which the manager restricts the extent to which his actions deviate from the interests of shareholders or bondholders. The emphasis is on information as part of a management control mechanism. In the alternative information function the emphasis is on the provision of information to investors to enable them to value securities and make "rational" investment decisions.³⁴ The emphasis is on information for market valuation.

I argue in section 3 that the emphasis in the accounting literature on the information function of financial statements is the result of actions of individuals in the political process: that it is the result of the Congress (or Parliament) and regulatory agencies such as the S.E.C. stating that corporate financial statements should provide information useful to investors in valuing securities in the capital markets. I doubt that the information hypothesis has as much potential as the agency cost hypothesis for explaining corporate financial statements in an economy without such government intervention. I have this doubt for several reasons.

1. The evidence suggests that corporate financial statements convey relatively little information which causes the capital markets to change the values of corporations' securities.³⁵
2. Managers are likely to have little incentive to supply information in corporate financial statements. Individuals who are the first to discover information relevant to the valuation of a corporation's securities (e.g., that oil has been discovered) can trade on that information and increase

³³For example, see the American Accounting Association, Committee on External Reporting (1969) and the American Institute of Certified Public Accountants Study Group on the Objectives of financial Statements (1973, p.13).

³⁴For examples of the emphasis see Staubus (1969, p.651) and Chambers (1968).

³⁵For U.S. evidence see Ball and Brown (1968) and Foster (1977). For Australian evidence see Brown (1970).

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their wealths. I expect them to trade until the prices of corporations' securities are equal to their estimates of the equilibrium prices of the securities, given the information. People will invest in the production of such information until they earn a "normal" return on the marginal dollar invested. Thus, corporate managers can only supply information in corporate financial statements if two conditions are met. The first condition is that they have access to information about corporations' values (e.g., their future cash flows) before outsiders gathering such information discover it or surrogate information (a plausible assumption). The second condition is that they be able to maintain exclusive access to that information until the financial statements are published (an implausible assumption). If managers cannot supply information relevant to the valuation of the corporations' securities to the capital markets in financial statements, they will not be rewarded for such information production.³⁶ Note that they are rewarded for contracting to supply information for monitoring bonding covenants at the times of entering into the covenants. They are rewarded by being able to sell the shares or bonds at higher prices with the covenants than without them.

3. CORPORATE FINANCIAL STATEMENTS AND THE POLITICAL PROCESS

3.1 *The Political Process and Financial Statements*

In the previous section I examined the determination of corporate financial statements in an unregulated economy. Modern economies are regulated. There are Companies Acts in the U.K. and Australia which require disclosure of particular items in financial statements and there are government agencies such as the Securities and Exchange Commission (S.E.C.) which regulate the contents of financial statements. A theory of corporate financial statements should explain the extent to which such government requirements and regulations affect financial statements. Ideally it should predict the government requirements and regulations themselves.

There has been substantial interest in the theory of government in recent years. Much of this interest was stimulated by Downs (1975a and 1957b) and Buchanan and Tullock (1962). The prime contribution of economists to this literature has been to introduce the assumption that individuals in the political process (e.g., voters, elected and appointed officials) maximize their own self-interests (i.e. expected utilities).³⁷ The literature on the application of economics to the political process has been classified into two non-mutually exclusive sets: Mueller (1976) describes one set as the literature on "public choice"; and Posner (1974) describes another set as "theories of economic regulation."

The theory of government is not yet developed to the stage that we can predict when and how corporate financial statements will be regulated. However, we can identify some variables involved in that process and hence can formulate some hypotheses about disclosure regulations and managers' reactions to them. In this section I demonstrate how one can generate such hypotheses on the basis of the assumption that individuals maximizing their expected utilities.

3.1.a *Information in the political process*

One important variable in the theory of government is identified by Downs (1957a and 1957b). That is that the probability of one individual's vote affecting an

³⁶This result does not require the assumption that has been popularized by Gonedes and Dopuch (1974), that information in financial statements is a public good.

³⁷See Buchanan and Tullock (1962, pp.17-39) and Meckling (1976a).

election outcome usually is very small. Hence, the expected value of the voter's own vote is trivial. As a result, he has little incentive to incur costs to gather information relevant to his vote. Further, the number of bills proposed by a legislative body during a legislative term is large. The costs to the individual of keeping track of his representative's vote on each bill and of determining the effect of that bill on his own expected utility are likely to be large. Thus, I expect that the information an individual uses in making voting decisions is acquired as a by-product of other activities. Examples of these other activities would be trade-union membership, watching television news reports for entertainment, etc.

Jensen (1976b) and Meckling (1976a) argue that if individual voters have little incentive to demand information on the effects of their representative's actions and related political phenomena, then the media have little incentive to supply such information. As a consequence, Jensen (1976b) predicts that news programs on television, newspapers, etc. would tend to provide simple explanations of the political process: explanations which entertain rather than inform. For example, he suggests that such entertainment would lead to some groups in any political conflict being cast as "good" and other groups as "evil".

Jensen (1976b, pp.20-22) argues that crises (impressions of impending disaster caused by natural phenomena or by individuals) are entertainment and thus the news media has incentives to create them. Jensen and Meckling (1976a, pp.21-22) argue that politicians also have incentives to create crises. Politicians create crises and then come to the rescue with simple legislative "solutions". For example, the crisis that unions and monopolies are creating inflation requires price controls [see Meckling (1976a, p.21)]. These "solutions" almost invariably increase the resources controlled by government and hence the resources controlled by elected representatives.

It is instructive to contrast information production in the political sector with information production in the capital market. It is often argued that small investors have little incentive to acquire information relevant to the valuation of securities.³⁸ Nevertheless, security prices reflect such information. Since entrepreneurs can capture the benefits of the information by trading on it, they bear the costs of production. Hence security prices can reflect information and serve as efficient signals for resource allocation. However, it is costly for political entrepreneurs to capture the benefits of information relevant to the political process. They can not directly buy votes, or claims to the effects of votes like the entrepreneur in the capital market who can buy securities. Hence information produced for political decisions is not likely to be of the same calibre as information on which security prices are based. Crises and simple "solutions" will abound.

3.1.b Crises and the regulation of corporate financial statements

Crises have a long history in justifying legislative actions which affect corporations. For example: the South Sea Bubble, which was blamed on speculators, led to an Act of the U.K. Parliament in 1720 which prohibited the formation of joint-stock companies;³⁹ the failure of the City of Glasgow Bank "under conditions of fraud," led to the U.K. Companies Act of 1879;⁴⁰ the U.S. stock market crash, combined with the published attacks on corporate disclosure by Ripley and others, led to the Securities Act of 1933 and the Securities

³⁸For example, see Lorie and Hamilton (1973, chapter 5).

³⁹Littleton and Zimmerman (1962, p.80). Also see Alchian (1976), who reports that the law did not effectively prevent the formation of joint-stock companies.

⁴⁰Edey (1968, p.138).

Exchange Act of 1934;⁴¹ the recent mining boom and bust in Australia led to the Rae Committee Report and to the recent proposals for federal regulation of securities markets. There is no doubt that significant economic events did occur at these times. What is doubtful is the validity of the simplistic explanations used by legislators to justify legislative actions to remedy the crisis.⁴²

Many crises which led to corporate regulation and, in particular, to regulation of corporate financial statements were blamed by political entrepreneurs on the lack of adequate corporate disclosure or misleading corporate disclosure. For example, U.S. politicians claimed that inadequate corporate disclosure was partially to blame for the stock market "crash" of 1929. Benston (1969, p.23) reports that the idea "that investors had been defrauded or, at least seriously misled by inadequate disclosure of the financial affairs of corporations" was an important rationale for the U.S. Securities Exchange Act of 1934 which established the S.E.C. Mundheim (1964, p.648) puts the idea succinctly: "The theory of the Securities Act is that if investors are provided with sufficient information to permit them to make a reasoned decision concerning the investment merits of securities offered to them, investor interests can be adequately protected without unduly restricting the ability of business ventures to raise capital."

Empirical evidence suggests that the stock market uses information from sources

⁴¹Benston (1969, pp.52-53) reports that despite Ripley's attacks on corporations for releasing confusing financial reports, a careful examination of the Senate hearings that preceded the Securities Act of 1933 [U.S. Congress, Senate (1933)] turned up only one citation of fraudulently prepared financial statements.

⁴²Neither the U.S. Senate Hearings [U.S. Congress, Senate (1933)] prior to the Securities Act of 1933 nor the Rae Report [Australia, Senate (1974)] provides systematic evidence to support their conclusions. Benston (1969) deals with the U.S. Senate Hearings. In Australia, the Rae Report [Australia, Senate (1974, p.1.1)] states that:

The main finding of this Committee is that the regulation of the securities markets, of the intermediaries which operate in these markets, and of some of the activities of public companies and investment funds, is in need of fundamental reform. Our essential recommendation is that an Australian Securities Commission be established forthwith by the Federal Government to carry out this reform.

The objectives of such legislation and thus presumably the criteria for the establishment of the commission are listed on page 16.15:

(i) The first is to maintain, facilitate and improve the performance of the capital market in the interests of economic development, efficiency and stability.

(ii) The second is to ensure adequate protection of those who invest in the securities of public companies and in the securities markets.

At least one of the objectives appears to be economic efficiency. Yet nowhere in the Rae Report is there any attempt to systematically estimate the resource cost of such legislation or to assess the benefits. All that is provided is a series of case studies of a few frauds (the same cases appear in several chapters). The mere existence of fraud is not sufficient to show a "need" for legislation since we would not expect it to be optimal to eliminate all fraud (because of costs). Moreover, in a period of uncertainty about future cash flows following apparent new mineral discoveries, the optimal rate of fraud is likely to be higher than normal.

other than the financial statements in valuing securities. Numbers in financial statements (e.g., sales and net income) are reflected in stock prices before the numbers are announced.⁴³ While some of the price adjustment is caused by "leaking" of the numbers in the financial statements, some of the adjustment occurs because the information is available from alternative sources (e.g., trade information such as that included in the Commercial Chronicle in the U.S. in the nineteenth century).

It is highly unlikely that the 1929 "crash" (or any other widespread drop in security prices) was due to inadequate disclosure by corporations. Further, the U.S. Senate Hearings preceding the U.S. Securities Acts do not provide any systematic evidence to support the conclusion that inadequate disclosure led to the 1929 crash.⁴⁴ It appears that blaming the crash on the lack of disclosure and then regulating disclosure was a convenient "solution" for political entrepreneurs.

3.1.c The effect of crisis regulation on bureaucratic behaviour

I assume bureaucrats appointed to administer corporate disclosure laws maximize their own expected utilities. The bureaucrats' careers and hence their expected utilities are affected by the likelihood of being blamed for future "crises". Thus, I expect bureaucrats to consider the effects of alternative regulations on the likelihood of blame when they draft and interpret regulations on corporate financial statements. Consequently, in order to predict the regulations of agencies such as the S.E.C. I must predict the effects of different regulations on the likelihood of blame for crises.

Losses due to actions are more apparent than losses due to inactions. Hence it is easier for politicians to attach blame for the former type of losses (i.e., the story is easier to sell). For example, when a drug is issued, the losses it causes (e.g. loss of life or deformed babies) become apparent. If a drug is not issued, the lives lost due to the unavailability of the drug are not apparent. Consequently, we would expect the bureaucrats in charge of allowing new drugs to be issued (e.g. the U.S. Federal Drug Administration) to weigh potential losses due to issuance heavier than potential losses due to withholding. Hence they would make the tests of drugs more stringent than might otherwise be optimal.

I expect a similar bias in the regulation of disclosure of corporate financial statements. Failures of large corporations are potential political crises. The losses to shareholders are apparent. Ex post it is easy to claim that assets were overvalued. On the other hand, undervaluing assets is unlikely to lead to any political crises if the corporation is successful. It is much more difficult for the shareholders and voters to observe any losses due to the undervaluation. As a consequence, I would expect bureaucrats to specify rules which encourage management to undervalue assets in corporate financial statements.

A bias towards undervaluation of assets in corporate financial statements would also be expected in an unregulated economy in inflation. Market values of assets for use in monitoring covenants are costly to obtain. There might not be a readily-observable market price for fixed assets and an independent assessment can be costly. Hence, in an unregulated economy I would not expect to observe continuous revaluation of assets. Revaluations would occur when the effect on agency costs of the disparity between market value and book value exceeded the cost of revaluation.

⁴³See Fama (1976) for a summary of evidence on the efficient markets hypothesis and Gonedes and Dopuch (1974) for a summary of the evidence on the relationship between numbers in financial statements and stock prices.

⁴⁴See n. 42.

When the bureaucratic bias towards undervaluation in the regulated economy is added to the bias caused by the costs of revaluation, I would expect the extent of undervaluation to increase. This provides a testable hypothesis about the effect of the political process on corporate financial statements.

Hypothesis 6: The assets in corporate financial statements are more undervalued in an economy in which disclosure regulations are set by bureaucrats than in an unregulated economy.

The hypothesis is consistent with observed phenomena in the U.S. Soon after the S.E.C. came into existence it effectively outlawed upward revaluations of assets.⁴⁵ Recently, that restriction appears to have been eased. In 1976 the S.E.C. issued Accounting Series Release No. 190 which required large listed corporations to disclose the replacement cost of inventories and gross property, plant and equipment.⁴⁶ However, the required disclosure is not in the financial statements themselves. It is by note or in a separate section of the report. The basis for asset valuation in the financial statements is still historical cost.

Hypothesis 6 could be tested in economies other than the U.S. where the content of corporate financial statements is subject to regulation by bureaucrats. However, in performing such tests one would have to be careful to select economies where the basis of valuation is set by bureaucrats and is not specified by statute. In the latter case the bureaucrat can blame the statute for crises "caused" by accounting procedures.

3.1.d The effect of crisis regulation on managers' behaviour

Watts and Zimmerman (1978) investigate the reaction of corporate managers to regulation of the contents of financial statements when information for voting decisions is costly. They argue that the corporate manager has an incentive to select accounting procedures and to lobby with politicians and bureaucrats for accounting procedures which reduce the net income reported in financial statements. Political entrepreneurs use "high" profits to create "crises". For example, the profits of U.S. oil corporations during the recent Arab oil embargo were used to justify bills to "break-up" large oil corporations.⁴⁷ Watts and Zimmerman (1978, p.8) also argue that the likelihood that reported net income will be used to justify political action increases with the size of the corporation.⁴⁸ Thus the manager of a large corporation is more likely to favour an accounting standard which decreases the net income reported in the corporation's financial statements than is the manager of a small corporation. This argument provides Watts and Zimmerman with a testable hypothesis.

Hypothesis 7: The larger the size of a corporation whose net income is increased (decreased) by a proposed accounting standard, the greater the likelihood that its managers will lobby against (for) the standard.

⁴⁵See Zeff (1972, pp.156-160) for an account of the circumstances leading to this action.

⁴⁶Ernst and Ernst (1976). The requirement applies to listed corporations whose total inventories and gross property, plant and equipment are more than \$100 million and more than 10% of total assets.

⁴⁷For example see a bill introduced into the Senate by Senator Bayh [U.S. Congress, Senate, Subcommittee on Anti-trust and Monopoly (1975, pp.5-13) and (1976, p.1,893)]. Note that it is absolute size and profits which are used as justification. On this point also see the "Curse of Bigness", Barrons, June 30, 1969, pp.1 and 8. Also see Alchian and Kessel (1962, p.162).

⁴⁸Watts and Zimmerman (1978). See also n. 47.

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Watts and Zimmerman observe the submissions to the U.S. Financial Accounting Standard Board concerning its discussion memorandum on general price level adjustments (issued February 15, 1974). They identify 26 non-utility corporations whose net incomes would be decreased by those adjustments. They are able to reject the null hypothesis that the attitude of the management of those firms towards the standard is independent of the firm's asset size at the .001 level. The management of the larger corporations tended to favor the proposed standard.

I am confident that the political process affects the choice of accounting procedures in Australia as well as in the U.S. For example, the use of replacement cost depreciation by Australia's largest corporation (The Broken Hill Proprietary Company Limited) is most likely due to that corporation's size and sensitivity to the political process. By reducing its reported profit, the corporation's managers are able to reduce the costs imposed by political entrepreneurs.

3.1.e Other effects

There are other effects of the political process on financial statements, in addition to those caused by "crisis" regulation. For example, corporate income taxes apparently had an important impact on the treatment of depreciation in corporate financial statements in the U.S. I noted earlier that at the beginning of the nineteenth century depreciation was regarded as an allocation of profits instead of an expense.⁴⁹ When depreciation was taken, usually it was charged to Retained Earnings and not to Income.⁵⁰

Depreciation came to be generally regarded as an expense in the U.S. and hence it came to be charged to Income during the early part of the twentieth century. It is highly likely that this change in attitude was due to the U.S. Revenue Act of 1913 which allowed depreciation as a deduction for the purpose of determining taxable income. Hatfield (1927, p.140) ascribes the change to that Act.

The Corporation Excise Tax Law of 1909 was passed in an effort to avoid a U.S. Supreme Court decision holding that an income tax law enacted in 1894 was unconstitutional. This law was itself declared unconstitutional, but it had a significant impact on the 1913 tax law passed after the Sixteenth Amendment to the Constitution. The Treasury (which administered the 1909 Act) ruled that "depreciation to be admitted as a deduction in calculating income must be recorded unequivocally on the books as such".⁵¹ A March, 1917 editorial in the *Journal of Accountancy* reports that, after the ruling, many corporate officials began charging depreciation as an expense in the corporate financial statements.⁵²

It is difficult to hypothesize why the Treasury required that depreciation be recorded as an expense. A potential hypothesis is that accountants lobbied for such a ruling because it reduced their costs of convincing corporate management to charge depreciation.⁵³

3.2 The Function of the Accounting Literature in the Political Process

If individuals involved in the political process maximize their own expected

⁴⁹Litherland (1968, p.171).

⁵⁰See n.29.

⁵¹Carey (1969, p.64).

⁵²Carey (1969, p.68).

⁵³Note that auditors were legally liable for breach of covenants, some of which involved depreciation.

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utilities, why does the accounting literature tend to assume otherwise?⁵⁴ The reason is that the function of the contemporary accounting literature is something other than to explain observed accounting practices. I will use the U.S. experience in the regulation of corporate financial statements to explain the real function of the accounting literature.

The S.E.C. was established as a "solution" to the crisis "caused" by inadequate corporate disclosure. One of the "inadequacies" of that disclosure was the diversity of accounting procedures used by corporate management.⁵⁵ The bureaucrats at the S.E.C. were motivated to reduce the diversity to avoid the blame for future crises.

The diversity of accounting procedures does not occur by chance. For example, in section 2 I predicted that accounting procedures would vary across corporations because of differences in agency problems (see Hypothesis 4). Accounting procedures can also vary across firms because of income tax rules.⁵⁶ Hence, changes in accounting procedures in order to reduce their diversity will impose costs on individuals. Those changes might increase agency costs or they might increase corporate taxes.⁵⁷ Consequently corporate managers will be motivated to lobby against attempts to reduce the diversity of accounting procedures.

The bureaucrats involved in reducing the diversity of accounting procedures have conflicting incentives. They have an incentive to appear to reduce diversity in order to avoid blame. They also have an incentive to avoid imposing costs on corporate managers and other individuals. Those managers could lobby with members of Congress to offset the bureaucrats' decisions, to reduce the S.E.C.'s budget, etc. The bureaucrats will choose the course which maximizes their own expected utilities.

The S.E.C. temporarily avoided the problem by delegating the responsibility for setting accounting standards to a committee of the American Institute of Certified Public Accountants, known as the Committee on Accounting Procedure (C.A.P.), soon after the S.E.C.'s formation.⁵⁸ But the C.A.P. failed to significantly reduce the diversity of accounting procedures.⁵⁹ The Institute then replaced the C.A.P. by the Accounting Principles Board (A.P.B.) which also failed in its task of reduction of the diversity of procedures. The Institute then replaced the A.P.B. by the semi-autonomous Financial Accounting Standards Board (F.A.S.B.) which currently sets standards in the U.S. However, Arthur Andersen and Co. recently has instituted a law suit which could force the S.E.C. to set accounting standards.⁶⁰

The C.A.P., the A.P.B. and the F.A.S.B. all tried to formulate a set of consistent principles to justify their selection of accounting standards. That is, they tried to formulate a story which could be used to forestall political

⁵⁴See n. 1.

⁵⁵Ripley (1927, pp.208-228) criticizes the lack of comparability of corporate financial statements in the 1920's.

⁵⁶For example in the U.S. corporations which use the last-in-first-out method of inventory valuation for tax purposes are also required to use that method in corporate financial statements.

⁵⁷See Watts and Zimmerman (1978) for a discussion of the types of costs which can be imposed on corporate management as a result of an accounting standard.

⁵⁸Zeff (1972, p.133).

⁵⁹Moonitz (1974, p.15).

⁶⁰See The C.P.A. Letter September 13, 1976, p.2.

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action by individuals affected by the standards. The C.A.P. and the A.P.B. failed.⁶¹ The F.A.S.B. has not used an underlying set of principles to justify the standards it has issued to date. The reason the C.A.P. and the A.P.B. were unable to find such a set of principles is that the only consistent explanation of the standards of the C.A.P., the A.P.B. and the F.A.S.B. would be based on the individuals involved in the process (managers, bureaucrats, accountants etc.) maximizing their own self-interests. However, it is not in the self-interest of the individuals on the C.A.P., the A.P.B. or the F.A.S.B. to justify the selection of accounting standards on that basis. I argued previously that voters would only tend to acquire their information on political choices as a by-product of some other activity. As a result, news media have incentives to entertain rather than inform; news stories are portrayed as a conflict between "good" and "bad" parties. Individuals motivated by self-interest are portrayed as "bad".⁶² Consequently, explaining the choice of an accounting standard on the basis of self-interest of accountants and corporate managers would not be an effective defense against the political actions of individuals harmed by the standard.

Because the only possible consistent explanation of a standard-setting group's selection of accounting procedures is politically costly, the group demands other explanations. These explanations must of necessity be inconsistent and must vary from circumstance to circumstance because they are not the underlying reasons. There is a demand for diverse prescriptions for accounting standards. I hypothesize that one of the major functions of academic accounting research since 1939 has been to supply those diverse prescriptions.⁶³ Because it is the "story" per se which is important and not the explanation of observed phenomena, there has been little incentive to confirm the hypotheses upon which any particular set of prescriptions is based.

Thus, the major function of the academic accounting literature is not the typical function of theory for an applied area. For example, the literature does not function to provide practitioners with a structure for choice among alternative practices and recommendations to clients. Instead, it functions to provide excuses. As a consequence, the academic literature does not lead practice except by chance, and it is little wonder that, after studying the history of the determination of accounting standards, Zeff comes to the same conclusion:

A study of the U.S. experience clearly shows that the academic literature has had remarkably little impact on the writings of practitioners and upon the accounting policies of the American Institute and the SEC. I seriously doubt that practitioners in this country, including especially the members of the American Institute's accounting principles committees, look to academics or to the American Accounting Association for inspiration, insight, or counsel. The evidence suggests that accounting theory is invoked more as a tactic to buttress one's preconceived notions, rather than as a genuine arbiter of contending views.⁶⁴

⁶¹See Moonitz (1974) and Zeff (1972) for accounts of these attempts.

⁶²See Jensen (1976, p.11).

⁶³Watts and Zimmerman (1977) trace the major developments in accounting theory this century and link them to the demand for "stories" (i.e., to the demand for excuses).

⁶⁴Zeff (1973). Zeff's investigation of the determination of accounting principles is given in Zeff (1972).

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4. CONCLUSION

I have endeavoured to outline the basic structure of a theory of financial statements and to provide examples of its constituent hypotheses. The apparent consistency of the hypotheses derived in this paper with observed phenomena confirms that the theory has great promise as an explanation of observed phenomena in accounting.

Watts and Zimmerman (1978) have tested one of the hypotheses provided in this paper. I hope that the Watts and Zimmerman paper proves to be the beginning of a literature in accounting whose aim is to explain accounting practice.

I cannot see the accounting professional bodies ever publicly accepting the theory outlined here. It assumes that accountants act in their own self-interests. Hence any endorsement is likely to impose substantial political costs on practicing accountants. Despite this, I have found that individual practitioners in both the U.S. and Australia agree privately with the idea that the contents of financial statements are the equilibrium outcome of individuals maximizing their own self-interests. Further, students who understand the elements of this theory have found the selection of alternate accounting procedures less confusing and have gone into practice with an analytical base which proves useful. This suggests that there might be a demand for this theory in professional education.

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